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No. 06-1286

IN THE

Supreme Court of the United States

MICHAEL J. KNIGHT, TRUSTEE OF THE WILLIAM L. RUDKIN TESTAMENTARY TRUST,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the
United States Court of Appeals for the Second Circuit

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INTRODUCTION

Petitioner has put forth a straightforward and easily administered reading of § 67(e): trust and estate investment management fees are incurred because the property is held in the trust or estate; they therefore are deductible in full. This is the only reading that is faithful to the language of § 67 and the text and structure of the Internal Revenue Code and the 1986 Act. Brief for Petitioner ("Pet. Br.") 22-31. It is the only reading consistent with the Code's net income taxation policy and with the broader income tax treatment of trusts and estates. Pet. Br. 24-28. It is confirmed, as concessions in the Commissioner's brief make clear, by the statutory history of the provision. Brief for Respondent ("Govt. Br.") 37-38; see *Powerex Corp. v. Reliant Energy Systems*, 127 S. Ct. 2411, 2416-17 (2007). And it provides the bright-line rule all agree Congress intended. Even without resort to the legislative history, which in any event supports Petitioner's position, Pet. Br. 31-37, it is thus clear that Petitioner's is the only sustainable reading of the statutory text. Nothing in the Commissioner's brief refutes this.

What the Commissioner proposes instead is yet another new position on the meaning of § 67(e), the third he has put forward during the pendency of this litigation. He does not defend his proposed regulation. He presents instead only the verbal test it contains, abandoning the proposed regulation's explicit, relevant instantiation of that test as one that calls for full deductibility of trust and estate investment advice fees, at least in some circumstances.

What he calls his "preferred" reading is that the statutory phrase "would not have been incurred" means "could not have been incurred." This reading is textually insupportable; it renders statutory language superfluous; it would, as the Commissioner's own brief reveals, create an administrative morass, despite § 67's conceded purpose to reduce costs of recordkeeping and auditing; and it ultimately excludes trust and estate investment management fees from full deductibility only because the Commissioner would apply it inconsis-

tently. This should all be unsurprising: The test was invented in error by the Court of Appeals below. It was never thought of before by the Commissioner, presumably because it is not what the text of the statute says. Indeed, he did not defend it even before this Court until its hurried inclusion in the proposed regulation he issued after the grant of certiorari in this case.

The Commissioner's Brief reveals further disarray. He asserts the statute is unambiguous (see Govt. Br. 32-33), while simultaneously (and inconsistently) arguing that it has "three linguistically permissible interpretations." Govt. Br. 7, 14. The first, he himself argues must be "rejected out of hand," id. 14; the next two are not textually supportable. All that appears to join the Commissioner's various positions is his insistence that they win this case for him. Yet at the end of the day he does not even have an explanation for why Congress would have wanted to subject fees like those for trust and estate investment management to the two percent floor. He urges only that they serve a purpose – to prevent income splitting – that even he concedes Congress did not have. Govt. Br. 37.

Just as this Court rejected the Commissioner's position in another recent case where "[t]he Commissioner . . . altered his arguments throughout the course of th[e] litigation," and, "particularly odd[ly]," "abandoned" the position that "predominated in the Commissioner's argument to the Court of Appeals," so, too, here this Court should reject each of the Commissioner's incompletely theorized proposed constructions. See *Gitlitz v. Commissioner*, 531 U.S. 206, 212 n.5, 218 n.8 (2001). The Court should adhere to the reading compelled by statutory text, structure and history, and reverse the judgment below.

ARGUMENT

I. Petitioner's Reading of the Statute is Correct.

Section 67(e) permits the deductibility in full of "costs which are paid or incurred in connection with the administra-

tion of the estate or trust and which would not have been incurred if the property were not held in such trust or estate." 26 U.S.C. § 67(e). That language establishes a straightforward causation test: an inquiry into whether a particular expense is due to the fact that the property was held in the trust or estate. Pet. Br. 22-23. A trustee's decision to obtain investment advice for the trust or estate is always a consequence of the trustee's demanding fiduciary duties regarding investments. Id. 6-10. That decision involves the exercise of fiduciary judgment. The advice for which investment advisory fees pay is tailored precisely to the distinctive requirements imposed by those fiduciary duties. The investment advisory fees incurred by trusts and estates would not have been incurred had the property not been held in the trust or estate. They are therefore deductible in full under § 67(e).

The Commissioner does not refute this argument because he cannot. Instead he presents a caricature of our position: that costs are deductible in full if "they are 'incurred in fulfillment of the trustee's fiduciary obligation,' regardless of whether they would have been incurred in the absence of a trust." Govt. Br. 28-29 (quoting a portion of a sentence in Petitioner's Brief). That is not Petitioner's view.

Under Petitioner's reading of the statute (and its plain text) costs that would have been incurred regardless of who owned the property are subject to the two-percent floor. These include those costs "incurred in connection with the administration of the estate or trust" that are not affected by the trustee's unique fiduciary obligations, but that occur, just as they would for non-trustee owners, simply because of the trust's or estate's ownership of "the property." 26 U.S.C. § 67(e). Costs like trust and estate investment advice fees, on the other hand, are not costs that "would have been incurred" had the property not been held in the trust. That is why they are deductible in full.

Administrative costs of pass-through entities owned by the trust or estate are the archetypal example of costs subject

to the two-percent floor under the second prong of § 67(e). Even when a trust or estate owns such an entity, those costs are incurred by the pass-through entity (for example, an S-corporation) and not by the fiduciary of the trust or estate in fulfillment of any fiduciary obligation. Other categories of expense that similarly would have been incurred regardless of whether "the property" were held in the trust or estate include, for example, certain expenses incurred in connection with real property. See Pet. Br. 23. If investment property is held cooperatively or in a condominium, an association or condo fee associated with that property will be incurred regardless of who owns the property. It is attendant upon ownership of the property. It would be subject to the two-percent floor under § 67(e) because it would have been incurred even if the property had not been held in the trust or estate. Similarly, if a trust or estate owned a vehicle (for example, a decedent's car), the legally mandated insurance costs, which would be incurred by whomever owned the property, would be subject to the two-percent floor.[1]

The Commissioner concedes that ensuring that this type of cost was subject to the two-percent floor was precisely Congress's purpose in adding the second prong to § 67(e). The Commissioner agrees, as he must, that the statutory history demonstrates that "the addition of the second clause of 26 U.S.C. 67(e)(1)" was designed specifically to prevent deduction in full of administrative costs "passed down to [a trust] from pass-through entities in which the trust had invested." Govt. Br. 37. The Commissioner further concedes what the text of § 67 and the Internal Revenue Code more broadly reveal, that Congress was in fact unconcerned about the risk of income splitting between an individual and a non-

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[1] As these examples show, the Commissioner is wrong to state that "all expenses" incurred "in connection with the administration of" a trust or estate are incurred in fulfillment of the trustee's unique fiduciary duty. Govt. Br. 31 & n.10. Petitioner's reading does not render any language in § 67(e) superfluous. See Pet. Br. 23.

grantor trust or estate, the sole purpose he has put forward in support of his broad reading of the statutory exception to full deductibility. See id. 37. As this Court's recent decision in *Powerex Corp. v. Reliant Energy Systems* makes clear, such "statutory history" – unlike the often-debated "legislative history" reflected in Committee Reports, floor statements, and hearing transcripts – is an uncontroversial tool in determining the meaning of statutory text. 127 S. Ct. 2411, 2416-17 (2007) (per Scalia, J.). The concessions in the Commissioner's brief virtually prove Petitioner's case.

The conclusion is inescapable that Congress, in enacting § 67, did not intend dramatically to alter pre-existing law. See former 26 U.S.C. § 57(b)(2) (1977); Pet. Br. 12-13. Congress sought only to extend the two-percent floor to certain, limited trust- and estate-incurred costs like the administrative expenses incurred by pass-through entities owned by trusts and estates. Congress did not intend, as the Commissioner insists, to subject almost all of the costs incurred in connection with the administration of a trust or estate – including, prominently, trust and estate investment advisory fees – to the two-percent floor. The Commissioner's argument is especially implausible given that his construction would make § 67(e) inconsistent with the rest of the Code and indeed with the thrust of the very Section in which the language appears. See 26 U.S.C. § 67(c) (exempting trusts and estates from being treated as pass-through entities).

We agree with the Commissioner that the language used by Congress was not expressly limited to administrative costs of pass-through entities, but went "beyond the principal evil to cover *reasonably comparable* evils." Govt. Br. 35-36 (emphasis added) (quoting *Oncale v. Sundowner Offshore Servs., Inc.*, 523 U.S. 75, 79 (1998)). Section 67(e) does not, contrary to the Commissioner's contention, impose the two-percent floor on all costs that individuals are capable of incurring, or all costs customarily or commonly incurred by individuals. In addition to pass-through costs, the two-percent floor covers only trust and estate costs "reasonably

comparable" to those pass-through costs, like those we have described above.

Petitioner's interpretation of the statute draws a clear and readily administrable line, which is what all agree Congress intended. On one side of the line are costs caused by the fact that the property is held in the trust or estate. These remain fully deductible. On the other side are costs that would have been incurred regardless of who owned the property held in trust, including archetypally (but not exclusively) administrative costs associated with pass-through entities in which the trust or estate, rather than an individual, happens to have an ownership interest.

The various alternatives the Commissioner has proposed, in contrast, are so complex that the Commissioner thinks they will require (in one case) an unprincipled "safe harbo[r] or other guidance" concerning "allocation methods" in order to be manageable, Govt. Br. 24 n.7, or (in another case) a determination both of "the relevant population in which the expense must be 'common' (for example, all citizens, all taxpayers, or all taxpayers who satisfy certain criteria)," and of "what fraction of that population must incur an expense before the expense is considered 'common,'" as well as a "trial" concerning each expense "to determine what fraction of the population actually incurs the expense." Id. 21-22.

Petitioner's is the only reading of the statute consistent with the tax treatment of trusts and estates otherwise embodied in the text and structure of § 67, the 1986 Act in which it was adopted, and the Code more generally – something the Commissioner fails even to address. See Pet. Br. 23-31. The text, structure and history of § 67, the 1986 Act, and the Code more broadly thus all confirm Petitioner's reading of the statute.

II. The Commissioner's New, "Preferred" Reading is Wrong.

The Commissioner's "preferred" reading of the statute sets out another new position on the meaning of § 67(e), the

third he has put forward during the pendency of this litigation. The Commissioner suggests that the "best" reading of the phrase "costs . . . which *would not* have been incurred if the property were not held in such trust or estate," 26 U.S.C. § 67(e) (emphasis added), is to refer to costs which "*could not* have been incurred by an individual property owner." Govt. Br. 20 (citing Pet. App. 13) (emphasis added).

Although his reading uses the verbal formulation contained in his proposed regulation, the Commissioner does not actually defend that regulation, but argues something new. The proposed regulation includes an explicit instantiation of that test with respect to precisely the type of fee at issue here. It says that the only investment advice fees subject to the two-percent floor are those for "advice on investing for total return" – the investment strategy prescribed for individuals by modern portfolio theory. Pet. Br. App. 14a (Proposed 26 CFR 1.67-4(b)); see Pet. Br. 17-18. Indeed, it expressly requires the taxpayer to "identify the portion (if any) of the . . . investment advisory . . . fee, commission or expense that is . . .not subject to the 2-percent floor." Pet. Br. App. 15a (proposed 26 CFR 1.67-4(c)).[2] The Commissioner does not de-

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[2] That this is what the proposed regulation means was confirmed in public remarks by a representative of the Office of Tax Legislative Counsel in the Department of the Treasury's Office of Tax Policy at an American Law Institute-American Bar Association program on September 20, 2007, just weeks before the Commissioner filed his brief in this case. The representative explained that under the proposed regulation the question was whether the services for which a fee was incurred were "obtained for purposes that are unique to fiduciaries that will not be subject to the two-percent floor. . . . If you have something like . . . investment advisory fees that . . . [were] incurred in part for services that are unique and in part for services that are not unique, you're going to have to apportion them. . . . Now the reg. also gives some bright lines in terms of what is clearly not deductible, not exempted from the two-percent floor, and that talks about investment advisory fees incurred for investing for total return. . . ." Responding to the moderator's observation that "I would have thought that investing for reasonable income and reasonable growth would have been unique to fiduciaries," she explained, "That's what we're saying. . . . If you're investing for total growth, total return,

fend this interpretation of the statute, presumably because the concession it implies – that fees for advice about investment of trust or estate assets that differs from that provided to individuals are, indeed, deductible in full – would be fatal to his case.

A. Text. The statute asks whether costs "would not have been incurred if the property were not held in such trust or estate." The Commissioner struggles to show that "would not" means "could not." But none of his verbal gymnastics can do that.

His primary argument, that when you remove the double negative "would not" means "could not," is just wrong. Govt. Br. 18. Asking without a double negative what costs "would not have been incurred if the property were not held in such trust or estate," is to ask what costs were incurred because the property was held in such trust or estate. That is precisely how Petitioner reads the statute.

The Commissioner also ignores the subjunctive form of the phrase "would not," then, treating the word "would" merely as the past tense of the verb "will," changes the tense of the word to try to prove his point. Id. But, as he elsewhere reminds us, "Congress' use of a verb tense is significant in construing statutes." Id. 30 n.9 (quoting *U.S. v. Wilson*, 503 U.S. 329, 333 (1992)); see *Sutton v. United Air Lines, Inc.*, 527 U.S. 471, 482 (1999). And even that change of tense would not suffice to help the Commissioner, since saying one "will not" incur an expense does not mean he or she "could not" incur it. His argument requires the further leap – not a part of the statutory text regardless of verb tense

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without having to worry about how much is income and how much is principal growth, that's the same as any investor is going to be doing. Whereas I don't think any individual would invest to produce X amount of income and X amount of principal growth and balancing those. . . ." Remarks of Catherine V. Hughes at the ALI-ABA program "Advanced Estate Planning Practice Update," audio at 4:30-5:39, 7:57-8:46, available for download through http://www.ali-aba.org/index.cfm?fuseaction=online.course_products&containerid=39231).

– that "the only way to be certain" that improper expenses are not deducted is to limit those deductions to those that "could not" be incurred by individuals. Govt. Br. 19.

The Commissioner's "parsing" of the logical structure of the clause suffers from additional infirmities. First, the Commissioner purports to "reorder" the statutory provision – though without mentioning it, he drops the word "such," so that his inquiry is no longer about ownership by the trust or estate at issue, but simply about property "held in trust" – something that inappropriately changes the focus from the action of the trustee of the particular estate or trust holding the property to the abstract category of the type of entity holding the property. Govt. Br. 19-20. When he replaces the actual language of the statute with the letters A and B, he again changes the tense of the statute. Id. Without this sleight of hand, a properly "reordered" version of the second prong would read "if the property were not held in the trust or estate, the cost would not have been incurred." This is "the logical equivalent of the proposition," id. 20, that the cost was incurred because the property was held in the trust or estate, the very reading Petitioner has urged all along. See David Hume, An Enquiry Concerning Human Understanding 83 (Open Court Publishing 1949) (reprint of posthumous edition of 1777) (classically explaining that counterfactual conditional phrases, like the one in § 67(e), ask about causation). Any example using the structure of the second prong proves this: "We would not have rented the car if we were not driving to Akron" means that the need to drive to Akron caused the rental of the car. The second prong states a test of causation, just as Petitioner has asserted.

And indeed, even with his sophistical twists and turns, the Commissioner's parsing still does not show that "would not" means "could not." The proposition that he claims is logically equivalent to the one contained in the statutory sentence – "the cost would be incurred only if the property is held in trust" (Govt. Br. 20) – still contains the word "would." He must again make a leap, stating that "the only

costs" for which the statement in his rewritten and reordered clause is "always true" are those which "could not" be incurred by any individual. Id. 20. But of course the statute does not ask about costs for which anything is "always true." It asks about costs that would not have been incurred if the property were not held in the trust or estate.

This reflects the inescapable problem with the Commissioner's countertextual reading of the statute. "Would not" does not mean "could not." To show that a cost "would not" have been incurred by a non-trust owner of the property requires no "categorical negation of the possibility" (id. 19) of such expenditure. In a candid sentence in the midst of his argument, the Commissioner says, correctly, "*one reason* that a cost would not be incurred in certain circumstances is that it could not be incurred." Id. 18 (emphasis added). Of course that is our point: many things that would not have occurred except for some event or circumstance *could have* occurred in the sense that they were possible. And, conversely, expenditures that no non-trust owner *could* have incurred are included in but do not exhaust the category of those that non-trust owners would not have incurred.

The Commissioner's own example demonstrates Petitioner's point. When one says "that a team would not have won the game if it were not for the quarterback's outstanding play," id. 19, one is saying his play was the cause of the victory. The team won because of the quarterback's play. One is not saying that it is impossible for any team to win without that quarterback. Yet this is the "impossiblity test" the Commissioner advocates.

The statutory language asks whether a cost "would not have been incurred if the property were not held in such trust or estate." If Congress had meant the statute to say that the only costs that were deductible in full were those that an individual could be shown to a "certainty" not to be capable of incurring, id. 19, it would have used different and familiar language: It would have said "could not have been in-

curred." And indeed, the Commissioner actually concedes that both of his various proposed interpretations "essentially add" a "modifier" to the statutory text. Id. 22 n.5.[3]

B. Superfluity. The Commissioner's proposed test also would render the first clause of § 67(e)(1) superfluous. The example he gives to contest this actually proves the point. See Govt. Br. 20 n.3. The Commissioner characterizes losses from bad debts as something that would be screened out from full deductibility by the first prong because, he says, they are not "paid or incurred in connection with the administration" of the trust or estate. Id. But individuals are capable of incurring bad debts. They do so all the time. These costs would therefore be screened out for full deductibility by the second prong under the Commissioner's reading, because they are not expenses of a type that an individual "could not have incurred." Under the Commissioner's interpretation, then, the first prong of § 67(e) is superfluous. He is unable to provide a single example of a cost that an individual "could not have incurred" that is not also a cost incurred in connection with the administration of a trust or estate. This demonstrates, if the words of the test he proposes did not, that the Commissioner's reading of the statute is wrong. Pet. Br. 45-46.

C. Administrability. The Commissioner also asserts that his chosen construction is the "preferable" one because

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[3] The applicable canons of construction support Petitioner's reading of the statute. Pet. Br. 38-40. The Commissioner relies on an argument that exceptions to general rules in statutes should be read narrowly. Govt. Br. 12. In the absence of textual ambiguity, there is no warrant for resort to any such default rule. In any event, to the extent that the Commissioner's rule is appropriately applied here, it supports a narrow reading of the two-percent floor, which is an exception to the general rule of full deductibility for miscellaneous itemized deductions, see 26 U.S.C. § 212(2) (stating the general rule that "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year . . . for the management, conservation, or maintenance of property held for the production of income."); cf. Pet. Br. 38. See *Commissioner v. Clark*, 489 U.S. 726, 739 (1989).

it "offers the most administrable approach." Govt. Br. 9, 21. He is wrong.

The Commissioner's rule is utterly unadministrable. As he describes, it requires "unbundling of unitary fees." Govt. Br. 23-24 n. 7. Given the utter complexity of determining, for example, the precise portion of a trustee's unitary trustee fee attributable to investment advice (assertedly subject to the two-percent floor) as against that portion representing some other service, the Commissioner's test will require taxpayers to make an "allocation" under "any reasonable method." Pet. Br. App. 15a. The difficulty of this task, plus the complexity and cost of auditing and litigating contestable apportionments of expenses under controvertible systems of allocation, plunges the taxpayer and the Commissioner into a morass. This is confirmed by public comments on the proposed regulation. See Appendix ("Rep. Br. App.") 3a-5a, 11a, 15a, 24a-25a (containing excerpts of these). The Commissioner recognizes this: indeed, he attempts to temper the problem created by application of his proposed standard with an offer of unprincipled "safe harbors" or other guidance concerning allocation methods. See Govt. Br. at 24 n.7; Pet. Br. App. 11a.

The difficulty of administering his rule not only demolishes the only argument the Commissioner has articulated for why he finds this textually insupportable construction "preferable," it also demonstrates that his construction is at direct variance with the intent of Congress. All agree that the purpose of the very adoption of the two-percent floor in § 67 was to get taxpayers and the IRS out of the business of doing precisely this kind of recordkeeping, allocating, and auditing. See Govt. Br. 33-34; Pet. Br. 24-25. Congress had no intention of introducing complex requirements for recordkeeping, cost allocation, and auditing in the very Section of the 1986 Act designed to eliminate that problem.

D. Departure from Past Practice. The Commissioner's proposed construction would also mark a radical

departure from the tax treatment given trust and estate expenses under the statute during the nineteen years since its adoption, subjecting fees and costs that he long agreed were fully deductible to the two-percent floor. While this alone might not definitively condemn a construction of the statute, it does suggest that his is not a plausible reading.

The Commissioner confirms the change, noting that, if his position is adopted, the IRS will, among other things, have to amend its Form 1041, as both attorney fees and accounting fees will no longer always be deductible in full. Govt. Br. 24-25 n.8. Attorney and accountant fees have not been broken out in IRS statistics, but, when combined with return preparer fees they totaled $3.171 billion in 2005. Internal Revenue Service, *Statistics of Income Tax Stats – Income from Trusts and Estates* ("*IRS Tax Stats*"), at Table 5 (IRS 2007) available at http://www.irs.gov/pub/irs-soi/05fd01.xls. They would, presumably, like other trust and estate expenses, be subject to the unmanageable regime of unbundling and cost allocation the Commissioner's interpretation calls for.

And, while trustee fees are not explicitly mentioned in the proposed regulation, the Commissioner now asserts that they would be "subject to its general unbundling requirement." Govt. Br. 24 n.7. This represents a dramatic departure from his prior position of nineteen years that trustee fees (totaling $4.0 billion in 2005, see *IRS Tax Stats*) are fully deductible – a position explicitly articulated by each Court of Appeals to accept his argument that investment advice fees are not deductible in full. See, *e.g.*, Pet. App. 12a; *Scott v. United States*, 328 F.3d 132, 140 (CA4 2003).

E. Reliance on Inconsistent Application of Expenses.

Even under the Commissioner's proposed test, trust and estate investment management fees would be deductible. The Commissioner's argument to the contrary relies on *ad hoc* and unprincipled distinctions among expenses.

Under the Commissioner's test "it is the type of product

or service rendered to the estate or trust, rather than the characterization of the cost of that product or service, that is relevant." Pet. Br. App. 14a. He argues that "costs paid or incurred for fiduciary accountings, judicial filings required as part of trust administration, [and] the preparation and filing of fiduciary income tax returns," among others, are fully deductible. Govt. Br. 23. Yet these categories of cost are "incapable of being incurred by individuals" only at the level of generality that the Commissioner refuses to use in describing trust and estate investment advisory fees. Pet. Br. 42-43.

Thus, *fiduciary* accountings are, at a broad level of generality, the same as accountings carried out by individuals who are not fiduciaries, for example, in the context of a divorce or a guardianship. The specifics compelled by the trustees' fiduciary duties, however, mean that the costs of fiduciary accountings are actually paying for a distinct service that individuals do not buy. Similarly, judicial filings *required as part of trust administration* are, at a broad level of generality, just like judicial filings by individuals. Even their subject matter may be identical. The same is true regarding *fiduciary* income tax preparation fees and the preparation fees for individual income taxes. See Pet. Br. 42-44.

As the Commissioner's position with respect to these costs correctly implies, when the services provided are distinct because they are tailored to the requirements of the fiduciary duty, the costs for such services are properly understood as distinct and incapable of being incurred by individuals. Because trust and estate investment advice must be tailored to the unique fiduciary duties of the trustee, the costs for such advice pay for a distinct service and they are, to precisely the same degree as each of these costs he concedes are fully deductible, incapable of being incurred by individuals.

The Commissioner has no answer to this point. Govt. Br. 25-26 (saying that neither the broadest nor the narrowest level of generality is correct, but not refuting Petitioner's claim that the Commissioner has been inconsistent in his

choice of level of generality); see Public Comments of the AICPA on proposed 26 CFR 1.67-4, Rep. Br. App. 11a ("the underlying logic for the classifications of different costs [by the Commissioner] is not explained and is inconsistent"). The Commissioner asserts that investment advice sought by trustees is not different in kind from the investment advice sought by individuals. Govt. Br. 26-27. But as Petitioner has explained, trustees' fiduciary duties do not allow them to make investment decisions in the same way as individuals would, or do. Pet. Br. 6-10. Among other things, only trustees need to balance the fiduciary obligation toward current and future beneficiaries and remaindermen, only they are bound to the distinctive "prudent investor standard," and only they face personal liability for failure to comply with their legal duties. Id.

The differences between trust investment advice fees and individual investment advice fees are at least as pronounced as the differences between the other fiduciary expenses the Commissioner recognizes are fully deductible and their individually-incurred counterparts. Should this Court adopt the Commissioner's test, it should apply it consistently to permit the full deductibility of trust and estate investment management and advisory fees.

III. The Commissioner's "Alternative" Reading Is Also Wrong.

The Commissioner also asserts (oddly and contradictorily) that he has not "abandoned" the different construction to which he long adhered, including in the court below, that the statute permits full deductibility only of costs of a type not "customarily" incurred by individuals. Govt. Br. 21 n.4. This "alternative" construction, too, is textually unsupportable and even the Commissioner now admits it is unworkable. Id. 21-22.

As explained in Petitioner's brief, the text does not ask whether expenses are "customarily" incurred outside of trusts. Pet. Br. 46-48. The Commissioner rehearses the

same arguments put forward below in support of this construction, still relying on the misuse of a dictionary definition of "would" – to refer to "custom or habitual action" taken in the past (e.g., "when we were young, we would go to the park every day") – that is wholly inapplicable here. Govt. Br. 20.[4]

As to workability, the Commissioner himself asserts that his alternative test would require a determination both of "the relevant population in which the expense must be 'common' (for example, all citizens, all taxpayers, or all taxpayers who satisfy certain criteria)," and of "what fraction of that population must incur an expense before the expense is considered 'common,'" as well as unimaginable "trial[s] to determine what fraction of the population actually incurs the expense." Govt. Br. 21-22. That cumbersome regime cannot be what was intended by a Congress seeking to ease administration of miscellaneous itemized deductions. And in the end, even the Commissioner rejects it. Id.

Finally, the Commissioner urges incorrectly that if this Court adopts that test, Petitioner should lose because he has failed to prove that investment management fees are not "customarily" incurred by individuals, and, the Commissioner asserts, under Tax Court rules Petitioner has the burden of proof on factual issues. Id. 28. This argument is easily dispensed with. The Commissioner has never put forward any evidence that such fees *are* customarily incurred by individuals, something that is far more likely to be available to him than to Petitioner, the CPA trustee of a family trust. As this Court has made clear, before the burden of proof is imposed on a taxpayer, the Commissioner must meet his burden of production: "[A] 'naked' assessment without any foundation" cannot be used to impose the burden of proof,

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[4] He attempts to bolster this with another dictionary definition, but selects another irrelevant one – to express "disposition or inclination," id., as in the phrase "I would propose we meet at noon." See Webster's Third New International Dictionary of the English Language 2638 (1986).

and thus tax liability, on a taxpayer. *United States v. Janis*, 428 U.S. 433, 441-442 (1976). On this record, therefore, under the Fourth and Federal Circuits' test, reversal would be the proper course.[5]

IV. The Legislative History Confirms Petitioner's Reading of the Statute.

This Court need not resort to legislative history because an examination of the statute's text, structure and history, along with the text and structure of the Code more broadly, demonstrates that it is unambiguous. Pet. Br. 31. In any event, the legislative history supports Petitioner here, and the Commissioner does not come to terms with it.

The Commissioner continues to cite a Senate Report issued before the second prong of § 67(e) was added to the bill, and asserts only that eliminating the deduction for investment advice fees is "consistent with" the "broader history of the Tax Reform Act of 1986." Govt. Br. 33. Specifically, he repeats his old argument that § 67(e) should be read as he urges because it "advances the goal" of deterring individuals from "split[ting] income" between a trust and its beneficiaries in order to obtain a tax benefit. Id. 34-35. The Commissioner never mentions the fact that the statute applies to "estates" as well, see id. 3 n.1 (refusing to address

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[5] The unremarkable assertion by this Court in a 1940 case that "a conservator of an estate, a custodian of a portfolio, a supervisor of a group of investments, a manager of wide financial and business interests, or a substantial stockholder in a corporation engaged in conserving and enhancing his estate" might deduct under § 162 as "ordinary and necessary expenses paid or incurred . . . in carrying on" their "trade or business" the "cost of investment counsel or of investment services," Govt. Br. 28, does not support the Commissioner's claim. See *Deputy v. DuPont*, 308 U.S. 488, 496-497 (1940). This case involves no taxpayer engaged in investment as a trade or business. The fees here were deducted under 26 U.S.C. § 212. Nor does "ordinary and necessary" mean "customarily incurred." See 26 CFR 1.212-1(d) (to be "ordinary and necessary," expenses must "bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income").

them), and of course there is no way (short of committing suicide) deliberately to set up an estate to split income between it and its beneficiaries. Pet. Br. 28. That alone refutes the Commissioner's argument.

More fundamentally, though, the Commissioner acknowledges, as described above, that "trusts and estates when they function like pass-through entities" "pose little risk of abuse," Govt. Br. 37. Congress recognized this in its treatment of trusts and estates in § 67(c) and throughout the Code, see, *e.g.*, 26 U.S.C. § 68(e), and in enactments both before and since the 1986 Act. Pet. Br. 30-31.

This concession deals the Commissioner's case a body blow. There is both specific statutory text and specific legislative history making clear that Congress thought significant changes in the taxation of trusts and estates was unnecessary to prevent the income-splitting that the Commissioner now urges as the sole purpose served by his reading of the second prong of § 67(e). Pet. Br. 37. Like so much else that conflicts with his position, the Commissioner leaves this – and indeed the very nature of trusts and estates and their taxation described by Petitioner, Pet. Br. 26-28 – unaddressed.

The Commissioner does not explain why the Congress that exempted trusts and estates from being treated as pass-through entities in § 67(c) would have nonetheless subjected almost all of their expenses to the two-percent floor.[6] He

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[6] Recognizing that these expenses have no personal component, the Commissioner suggests that Congress had a purpose in enacting the two percent floor to "simplify" tax administration that was distinct from its goal to prevent deduction by individuals of expenses with a personal aspect. Govt. Br. 33-34. But the congressional goals of "simplification" and "limit[ing] deductions for personal expenses" are one and the same. Id.; see Pet. Br. 25 (explaining this). It was because some portion of some individual expenses (including some he lists, *e.g.*, continuing education) was, in fact, often personal, that recordkeeping and auditing were burdensome. Congress grouped certain individual deductions, including but not limited to these, into the category denominated "miscellaneous itemized deductions." It then permitted a deduction for these costs *in the aggregate* only to the extent that they exceeded two percent of adjusted

does not dispute that prior § 57(b) made trust and estate investment management fees fully deductible before the adoption of the 1986 Act even when similar costs incurred by individuals were not. Pet. Br. 12. Nor does he dispute that the original versions of what is now §67(e) that passed both Houses of Congress contained that same rule. Id. 32. And indeed, as described above, he concedes that the specific problem that the new second prong was added in Conference to address was the possibility that trusts and estates might deduct in full expenses incurred by pass-through entities in which they held an ownership interest, Govt. Br. 37-38, something reflected in the Conference Report.[7]

The Commissioner resists the clear conclusion that the statute's language must be read to prevent only those and similar deductions, not dramatically to alter pre-existing law concerning the treatment of trust and estate administrative expenses. He provides no good reason for reading § 67(e) to prevent full deduction of trust investment management fees.[8]

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gross income. This method was designed to provide "rough justice" by in essence disallowing what Congress thought could fairly be deemed the personal *component* of those *aggregated* costs. Pet. Br. 24-25, 32-33.

[7] The Commissioner incorrectly asserts that the portion of the Conference Report quoted by Petitioner does not relate to Section 67(e). Its next-to-last sentence makes clear that it does. See Pet. Br. 35.

[8] The Commissioner appears to concede that his proposed regulation would not at this time be entitled to deference even in the face of statutory ambiguity. Govt. Br. 7; see Pet. Br. 48-49 n.33. Most of the public comments submitted on his proposed regulation – all of which disagree with his interpretation of § 67(e) – formally ask the Commissioner to extend the comment period or withdraw or hold in abeyance the proposed regulation until after this Court's ruling in this case in order to permit those comments or the agency's regulatory action to be informed by this Court's decision. See, *e.g.*, Rep. Br. App. 2a, 6a (American Bankers Association); 7a-8a (ABA Section of Real Property, Trust and Estate Law), 10a-12a (AICPA), 14a, 16a (AmeriServ Trust and Financial Services Company), 19a-21a (N.Y. City Bar). As of the date of filing of this brief, the Commissioner has not agreed to do so. See id. 8a.

V. As Economic Theory Predicts, Individuals Will Act at the Margin to Minimize Taxation.

Finally, the Commissioner erroneously suggests that trustees will not be deterred from seeking professional investment advice in fulfillment of their fiduciary duties by what he, the tax collector, calls "such a small amount of tax." Govt. Br. 39. Under the current top tax bracket, however, the tax will amount to as much as 35% of the cost incurred. The Commissioner falsely claims the tax will be limited to "0.7% of the trust's income." Govt. Br. 39. He is apparently referring to *adjusted gross income*, not *taxable income*. The additional tax could in fact be *any* percentage of the trust or estate's taxable income. Pet. Br. 10-11. Further, as the Commissioner knows, because of the Alternative Minimum Tax, the tax will not in any event be limited even to 0.7% of adjusted gross income.

In the real world, individuals act – as economic theory predicts – at the margin to minimize taxes, and the Commissioner's approach would provide plenty of incentive. See Pet. Br. 40-41; Rep. Br. App. 23a-24a (comments of Northern Trust Company). Indeed, his brief suggests further reason for concern. If trustee fees, too, are no longer fully deductible, the consequences for the banking industry, which provides most professional trustee services, and for the management and operation of trusts and estates, could be profound. Grantors and beneficiaries will tend to avoid using professional services in favor of trustees who are willing to serve at no cost – less skilled relatives, for example, or friends. At a time when state trust and estate law has been pushing toward the professionalization of the advice given to trusts and estates, for example by adoption of the "prudent investor" standard, Pet. Br. 7-10, it would make no sense to conclude that Congress intended such a perverse result.

CONCLUSION

The judgment of the Second Circuit should be reversed.

Respectfully submitted,

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Counsel for Petitioner

NOVEMBER 2, 2007

APPENDIX

APPENDIX A
Comments of The American Bankers Association
(Excerpt)

ABA
AMERICAN BANKERS ASSOCIATION ®

1111 Constitution Avenue, NW
Washington, D.C. 20044

1-800-BANKERS
www.aba.com

October 24, 2007

Ms. Linda E. Stiff
Acting Commissioner of Internal Revenue
Internal Revenue Service
1111 Constitution Ave, NW
Washington, D.C. 20044

Re: *Section 67* Limitations on Estates and Trusts; REG-128224-06; 72 Federal Register 41243 (July 27, 2007).

Dear Ms. Stiff:

The American Bankers Association (ABA) appreciates the opportunity to comment on the Internal Revenue Service's (IRS) proposed amendments to regulation *26 CFR 1.67*. The ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership -- which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks -- makes ABA the largest banking trade association in the country.

Many ABA members provide fiduciary and related services to individual and institutional clients. As of the end of

2006, approximately 1800 banks and thrifts held more than $ 19 trillion in fiduciary assets for both retail and institutional customers in 19 million accounts.[1] In their fiduciary capacity, these banks provide a number of services to customers of all kinds, such as trust administration, investment management, custody of assets, tax preparation and accounting. While acting as a fiduciary or trustee, banks must follow strict duties of loyalty, prudence, and care to the trust and its beneficiaries and are subject to liability for failure to comply with their fiduciary responsibilities. In exchange for providing trust and fiduciary services, banks charge fees that would be subject to the proposed amendments. As a result, the banking industry is very concerned about the proposal and the potential deleterious impact it would have on trusts and estates, their beneficiaries, and the banks that serve as fiduciaries for these accounts.

BACKGROUND

* * *

For several reasons, ABA respectfully opposes the proposal and urges, at a minimum, that the IRS delay any consideration of regulatory action until after the Supreme Court has decided the matter. First, the proposal misinterprets the plain meaning of *Section 67* and which expenses may be deducted in full. Second, the proposal ignores the significant and extensive fiduciary responsibilities imposed on trustees by state laws and the governing trust instruments that require trustees, in performing their fiduciary responsibilities, to consider investment management services. Third, not only is the proposal administratively difficult and costly to implement, but it also is likely to be harmful to beneficiaries.

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[1] FDIC Call Report Data, December 2006. As used in this letter, the term "banks" includes banks, savings associations, and trust companies that act in fiduciary and related capacities.

PLAIN MEANING OF SECTION 67(e)

* * *

FIDUCIARY RESPONSIBILITIES OF TRUSTEES

* * *

PRACTICAL CONCERNS AND ADMINISTRATIVE AND INDUSTRY BURDENS

The proposal, which would require bank trust departments and others to "unbundle" the fees charged to administer trust accounts, would be impractical and very costly to implement. Typically, banks charge each trust account a single fee for its administration. This fee covers fiduciary administrative services, including custody, tax return preparation, as well as investment services.

Separating the "unique" components of trust fees is a time-consuming and very burdensome exercise. Because of the very specialized nature of trust administration and significant fiduciary liability incurred, many institutions have a multiplicity of fee schedules for various types of trust accounts. These numerous fees schedules reflect the highly customized services offered and the specific needs of the beneficiaries. In other words, two trust accounts of a similar size and type could be charged two different fees depending on several factors, including asset mix, complexity of family situation, trust terms, number of beneficiaries, and structure of mandatory versus discretionary payments of income or principal. How then would the bank systematically and accurately determine the portion of fees that are "unique" for the two trust accounts? Such an allocation is far from a standardized process, and would likely require extensive individual determinations. Individual determinations, in turn, may lead

to the inequitable treatment of trust accounts and thus cannot be supported from a fiduciary standpoint.

Furthermore, assuming that compliance with the proposal is possible through a computerized process, the expense of that compliance would be significant. Invariably, bank trust departments would have to create yet another computer system to track, calculate, and separate the fees that are deductible from those that are not.[2] This system must be tested to ensure that it properly tracks the information, as well as periodically adjusted to accommodate new or different services the bank offers to each trust. Furthermore, the bank must institute on-going training programs for employees. All of these expenses would result in a significant cost for all institutions. This expense is especially burdensome for the hundreds of smaller institutions[3] that offer trust and fiduciary services and typically employ fewer than twenty full-time employees. Often these institutions employ no more than a handful of personnel in the trust department.

In addition to fulfilling their tax accounting and reporting duties, these trust department employees would now need to spend their time "unbundling" trust fees for the previous tax year. This complex and time-consuming activity, especially for smaller institutions with few employees, will likely delay other necessary tax reporting activities, such as issuing Schedule K-1s to trust beneficiaries. This delay could in turn cause those taxpayers to ask for an extension in their tax filings. Trust tax returns and tax information sent to beneficiaries must be completed in an extremely short amount of time -- especially when trustees must wait for records from partnerships. Under the proposal, the amount of time available to

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[2] The most popular computer systems used by bank trust departments are not capable of "unbundling" and tracking the trust fees.

[3] According the FDIC Quarterly Banking Profile for 2006, 400 banking institutions with assets under $100 million exercise fiduciary powers, such as acting as a corporate trustee.

compile the necessary tax forms would be further shortened if trustee institutions were required to comply with complex unbundling requirements. In the end, this requirement will not only burden trusts and estates and the bank trustees that serve them, it will also make the tax compliance system less efficient.

All of these practical concerns with implementing the proposed regulation would very likely lead to an increase in the fees for administering the trust. This increase in fees would incorporate the additional time and expense of training staff, creating new records systems, and making labor-intensive decisions about how to "unbundle" the fees properly. The costs associated with unbundling trust and estate fees will be passed on to the trust beneficiaries. We further submit that even under the proposal, the costs associated with "unbundling" would be fully deductible from the trust income, as they would be incurred as a result of the assets being held in trust.

In the end, we question who is helped by this proposal; certainly not the bank trustees who must spend resources to unbundle their fees, nor the beneficiaries that will incur higher fees to compensate trustees for their labors. We question how much the U.S. Treasury will benefit if our position is correct that costs associated with unbundling fees would be fully deductible.

EFFECTIVE DATE OF THE PROPOSED RULE

* * *

CONCLUSION

In conclusion, ABA appreciates the opportunity to offer our comments on the Section 67 proposal. At a minimum, the IRS should not move forward with this proposal until the

Supreme Court has had an opportunity to rule on the merits of the case before it. In addition, we would strongly urge the IRS to abandon this proposal, as it ignores the significant fiduciary duties of trustees and leads to far greater burdens than benefits.

Should you have any questions or comments with respect to the issues raised in this letter, please do not hesitate to call the undersigned at (202) 663-5053 or Lisa Bleier at (202) 663-5479.

Sincerely,
/s/ Phoebe A. Papageorgiou
Phoebe A. Papageorgiou
American Bankers Association
Washington, D.C.

APPENDIX B
Comments of the American Bar Association Section of Real Property, Trust and Estate Law (Excerpt)

COMMENTS OF THE REAL PROPERTY, TRUST AND ESTATE LAW SECTION OF THE AMERICAN BAR ASSOCIATION

REG-128224-06
(Section 67 Limitations on Estates or Trusts)

October 25, 2007

* * *

Comments and Recommendations

I. Withdraw Proposed Regulations or Extend Comment Period Until After the Supreme Court Has Ruled in *Rudkin*.

The Supreme Court has granted *certiorari* in *Rudkin*, and will examine this issue directly. Its decision in that case may address the different considerations and standards raised in decisions issued by four United States Courts of Appeals and may reconcile or eliminate the differences in opinions as to the scope of Section 67(e). *Certiorari* was granted in *Rudkin* even though the Treasury had opposed its grant. Treasury argued that the grant of *certiorari* was unnecessary because Treasury had prepared proposed regulations addressing the issue to resolve the different treatment of taxpayers in different circuits and would issue the proposed regulations shortly. Given the Court's implicit rejection of Treasury's position, it is appropriate to defer the regulatory process until the Supreme Court issues its opinion.

A member of the Section made an inquiry to Mr. Eric Solomon, Assistant Secretary for Tax Policy, as to whether Treasury would withdraw the Proposed Regulations or extend the comment period until at least 90 days after the Supreme Court issues its decision. Mr. Solomon would not give any assurance that Treasury would do either. Because we do not know whether the Proposed Regulations will be withdrawn, we address them in these comments. If the Proposed Regulations are not withdrawn, we respectfully request that the period to comment on the Proposed Regulations be extended until 90 days after the Supreme Court renders its decision in *Rudkin* to permit all interested parties to have the benefit of the reasoning in the Supreme Court's decision in formulating their comments. In conjunction with extending the comment period, we also respectfully request that the public hearing scheduled for November 14, 2007, be delayed until 30 days after the close of the extended comment period to avoid the possible need for a second hearing.

* * *

APPENDIX C
Comments of The American Institute of Certified Public Accountants (Excerpt)

October 8, 2007

Ms. Linda Stiff
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Mr. Donald Korb
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Mr. William P. O'Shea
Associate Chief Counsel for Passthroughs and Special Industries
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

HAND DELIVERED: Courier's Desk, CC:PA:LPD:PR
(REG-128224-06)

RE: Proposed Regulations (REG-128224-06) 2007-36 IRB 551, Regarding Guidance on Which Costs Incurred by Estates or Non-grantor Trusts Are Subject to the 2-Percent Floor for Miscellaneous Itemized Deductions Under Section 67(a)

Dear Ms. Stiff and Mssrs. Korb and O'Shea:

The American Institute of Certified Public Accountants (AICPA) is submitting comments on proposed regulations relating to guidance on which costs incurred by estates or non-grantor trusts are subject to the 2-percent floor for miscellaneous itemized deductions under section 67(a).

The AICPA is the national professional organization of certified public accountants comprised of approximately 330,000 members. Our members advise clients on federal, state and international tax matters, and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized business, as well as America's largest businesses.

We respectfully request that the comment period for the Proposed Regulations [REG-128224-06] be extended to end 90 days following the Supreme Court decision in Rudkin,[1] for the following reasons:

1. The proposed regulations provide little in the way of additional clarification of the statute. As a definition of eligible costs, the regulations merely repeat the statutory language, with an inconsistent substitution of the verb "could" for "would." For example:

   a. Section 67(e)(1) defines eligible costs, in part, costs "which would not have been incurred if the property were not held in such trust or estate."

   b. Proposed reg. section 1.67-4(b) states that an eligible cost is a "unique" cost, which is, in turn, defined as a cost where "an individual could not have incurred that cost in connection with property not held in an estate or trust."

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[1] Michael J. Knight v. Commissioner, No. 06-1286.

The proper interpretation of such language -- which is at the heart of the Circuit split -- is not explained further in the regulations.

2. The proposed regulations provide a list of eligible and non-eligible costs. However, they are of limited value because the underlying logic for the classifications of different costs is not explained and is inconsistent. For example, tax preparation costs incurred by trusts, appropriately, are held to be an eligible cost, while investment advisory fees incurred by trusts are not. Although both individuals and trusts incur tax preparation costs, the regulations, correctly, make the distinction between tax preparation fees incurred by trusts and those incurred by individuals based on the difference in reporting forms (Form 1041 vs. Form 1040) and tax law uniquely pertaining to trusts. Using the same logic, the nature of the investment advice for trusts -- for example, advice to carry out the specific terms of a trust, to achieve a certain balance between the income and remainder beneficiaries, or to comply with the prudent investor laws uniquely pertaining to trusts - -should render the fees for such advice fully deductible.

3. The portion of the proposed regulations that deals with unbundling fees will require trustees to develop allocation methods for bundled fees charged by a variety of vendors, including passthrough entities that do not provide the needed information. Corporate trust departments must explore the technical feasibility of the various options. Attorneys must consider the impact of attorney-client privilege on providing detailed disclosures to third parties. Requesting commentators to invest significant amounts of time to investigate options and propose such methods -- prior to the Supreme Court's ruling on the tax treatment of such items -- is unfair and burdensome because the Court's ruling may make these options moot.

4. Although the United States Courts of Appeals have interpreted the language differently, none of them have found the statute's language to be ambiguous. Acting under the Chevron doctrine[2], courts are required to defer to certain agency interpretations of ambiguous statutory provisions, provided the agency's interpretation reasonably resolves the ambiguity. However, if the statute is unambiguous, the courts are not required to defer to the agency's interpretation. None of the courts have held IRC section 67(e)(1) to be ambiguous. Therefore, the proposed regulations, even if finalized, are of no or limited value in resolving the present Circuit split prior to the Supreme Court's decision.

Based on the above, we respectfully request that the IRS extend the comment period for the proposed regulations to 90 days following the Supreme Court decision in Rudkin.

* * *

We thank you for the opportunity to present our comments and welcome the opportunity to discuss our comments further with you or others at the IRS. Please feel free to contact me at (212) 773-2858, or jeffrey.hoops@ey.com; Steven A. Thorne, Chair of the AICPA Trust, Estate, and Gift Tax Technical Resource Panel, at (312) 486-9847, or stethorne@deloitte.com; or Eileen R. Sherr, AICPA Technical Manager, at (202) 434-9256, or esherr@aicpa.org, to discuss the above comments or if you require any additional information.

Sincerely,

Jeffrey R. Hoops

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[2] Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984)

Chair, AICPA Tax Executive Committee
Washington, D.C.

cc:
Mr. Eric Solomon, Assistant Secretary for Tax Policy,
Treasury Department
Ms. Catherine Hughes, Attorney Advisor,
Treasury Department
Ms. Jennifer N. Keeney, Attorney, Office of Associate Chief
Counsel for Passthroughs and Special Industries, IRS
Mr. George Masnik, Branch Chief, Office of Associate Chief
Counsel for Passthroughs and Special Industries, IRS

APPENDIX D
Comments of AmeriServ Trust and Financial Services Company (Excerpt)

AMERISERV
TRUST AND FINANCIAL
SERVICES COMPANY

October 9, 2007

CC:PA:LPD:PR (REG-128224-06)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

To Whom It May Concern:

AmeriServ Trust and Financial Services Company ("AmeriServ") appreciates the opportunity to provide comments on Prop. Treas. Reg. § 1.67-4 regarding the deductibility of certain costs paid or incurred by estates or non-grantor trusts.[4]

* * *

AmeriServ urges the IRS and Treasury (i) to amend Prop. Treas. Reg. § 1.97-4 to provide that costs incurred by fiduciaries to comply with obligations imposed under state law are fully deductible, and (ii) to extend the comment period beyond October 25, 2007 for a reasonable period following the

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[4] Unless otherwise indicated, references herein to "IRS" are to the Internal Revenue Service; references to "Code" are to the Internal Revenue Code of 1986, as amended; references to "Section" are to the specified sections of the Code; and references to "Treas. Reg. §" are to the Treasury Regulations promulgated under the Code.

Supreme Court's ruling in *Knight v. Commissioner* (No. 06-1286).

* * *

Comments and Recommendations

1. Prop. Treas. Reg. § 1.67-4 should be amended to account for the manner in which fiduciary obligations impact costs incurred by non-grantor trusts and estates.

* * *

AmeriServ also cautions that Prop. Treas. Reg. § 1.97-4 will have an unintended effect of increasing the costs of administration for estates and non-grantor trusts. Under the Regulation as proposed, fiduciaries will be required segregate their fees, which often are bundled at a savings to customers, into expenses that are unique to estates and trusts, and therefore fully deductible, and expenses that are not. Creating systems to track unique expenses will be difficult and costly and is likely to result only in increased fees. Smaller financial institutions may lack capacity to implement new systems, making compliance difficult for taxpayers. Accordingly, Prop. Treas. Reg. § 1.97-4 should be revised as recommended above for the added reason of avoiding a cumbersome systemic shift which will make estates and trusts expenses difficult and costly to track.

2. Regulations interpreting Section 67(e) should remain proposed and subject to public comment pending the Supreme Court's decision in *Knight*.

The comment period for Prop. Treas. Reg. § 1.67-4, which essentially codifies the Second Circuit's holding in *Rudkin*, ends on October 25, 2007. However, *Rudkin's* ultimate dis-

position will not be certain until the Supreme Court's ruling in *Knight*.

* * *

It is entirely possible that the *Knight* ruling will reverse the Second Circuit in *Rudkin* and thereby call into question the validity of Prop. Treas. Reg. § 1.67-4. The IRS and Treasury have less discretion implementing a statutory provision after a court decides what a statute means. Accordingly, AmeriServ urges the IRS and Treasury to extend the comment period for any proposed Regulations interpreting Section 67(e) for a reasonable period following the *Knight* ruling. Nearly fifteen years have passed since the first important ruling on this issue in O'Neill. The Supreme Court in its *Knight* opinion might invite Treasury and the IRS to clarify the area by writing regulations of any kind, but also might explain that Treasury's and the IRS's interpretive options under the clear statute are limited. There is no compelling reason to expedite Section 67(e) guidance in advance of the issuance by the Supreme Court of its opinion, especially where doing so could result in an additional lack of clarity.

Sincerely,
/s/ Ronald Virag
Ronald W. Virag
President and Chief Executive Officer

cc: Jennifer N. Keeney,
Office of the Associate Chief Counsel (Passthroughs and Special Industries)
Jeffrey H. Paravano
Natanya Holland Allan

APPENDIX E
Comments of the Association of the Bar of the City of New York (Excerpt)

NEW YORK CITY BAR

COMMITTEE ON ESTATE AND GIFT TAXATION

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October 24, 2007

Via Electronic Submission and Express Mail
http://www.regulations.gov/
IRS – REG-12822406

Internal Revenue Service
Attn: CC:PA:LPD:PR (REG-128224-06)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments to Proposed Treas. Reg. § 1.67-4 Concerning Whether Certain Costs Paid or Incurred by Estates or Non-grantor Trusts are Subject to the 2% of Adjusted Gross Income Floor

Dear Ladies and Gentlemen:

This letter sets forth the comments of the Association of the Bar of the City of New York to Proposed Treasury Regulation § 1.67-4, which was issued on July 27, 2007 (the "Proposed Regulations"). . . .

As discussed below, we strongly urge the Service to hold the Proposed Regulations in abeyance pending the Supreme Court's resolution of the Rudkin-Knight case,[2] which involves the construction of the specific statutory provision that is addressed by the Proposed Regulations, *to wit*, I.R.C. § 67(e) ("Section 67(e)"). We also request that the Service extend the comment period for the Proposed Regulations until 90 days after the Supreme Court decides Rudkin-Knight.

With respect to the substance of the Proposed Regulations, we believe that the Proposed Regulations are unreasonable in construing Section 67(e) to require that "bundled" trustee's fees and commissions be unbundled, and note that the Service's position is contrary to the views expressed by each of the federal appellate courts that have commented upon (and approved) the deductibility of trustee's fees without regard to the 2% Floor.[3] We also regard the Proposed Regulations to be somewhat arbitrary in their delineation between those costs that the Service considers "unique" to an

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[2] See Knight v. C.I.R., 127 S. Ct. 3005 (U.S. June 25, 2007) (granting for the certiorari from the Second Circuit's in William L. Rudkin Testamentary v. C.I.R., 467 F.3d 149 (2d Cir. 2006)).

[3] See Rudkin, 467 F.3d at 156; Scott v. United States, 328 F.3d 132, 140 (4th Cir. 2003).

estate or trust (and are therefore fully deductible without regard to the 2% Floor), and those costs that are not (which are therefore subject to the 2% Floor), and urge the Service to conform its classification scheme to the parameters that will soon be announced by the Supreme Court in the Rudkin-Knight case.[4]

I. The Proposed Regulations Should Be Held in Abeyance Pending the Supreme Court's Decision in the Rudkin-Knight Case and the Comment Period Should Be Extended Until 90 Days after This Decision is Rendered

We were surprised that the Proposed Regulations were issued so soon after the Supreme Court's granting of certiorari in the Rudkin-Knight case, which involves the construction of the specific statute (Section 67(e)) that the Proposed Regulations interpret. It would be unfortunate if the Services' actions served to undermine the balance of power among the judicial, executive and legislative branches of the United States government. Moreover, as a practical matter, if the Proposed Regulations are finalized without taking into consideration the Supreme Court's forthcoming decision in the Rudkin-Knight case, taxpayers might find themselves in a conundrum where different standards for interpreting Section 67(e) will have been promulgated by the Service and the Supreme Court – thereby producing more litigation on this issue. Accordingly, we strongly urge the Service to reconsider its position, and to hold the Proposed Regulations in abeyance pending the resolution of the Rudkin-Knight case. In addition, to permit the Proposed Regulations to be evaluated in light of the Supreme Court's forthcoming guidance,

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[4] Although these Comments only address the specific points set forth herein, we fully adopt and agree with the positions taken by the Petitioner/Taxpayer in the Rudkin-Knight case. Given the Service's extensive familiarity with the issues presented in that case, we have not repeated those arguments here.

we respectfully request that the Service extend the comment period for the Proposed Regulations until 90 days after the Supreme Court decides Rudkin-Knight.

II. The Proposed Regulations' Requirement that "Bundled Fees" be Unbundled Should Be Eliminated

* * *

III. The Service Should Await Guidance from the Supreme Court before Delineating Categories of Costs

* * *

Although we appreciate the Service's objective to provide taxpayers and their advisors with bright-line rules (notwithstanding that these rules may contain some internal inconsistencies), we believe that the better approach would be for any such guidelines to be informed by the standards that will soon be handed down by the Supreme Court in the Rudkin-Knight case. Accordingly, the issuance of these guidelines should be held in abeyance pending the Supreme Court's decision in Rudkin-Knight and the Service's review of comments to be submitted within 90 days after this decision is rendered.

Respectfully submitted,
/s/ Michael I. Frankel
Michael I. Frankel
Chair, Estate & Gift Taxation
Committee

* * *

APPENDIX F
Comments of Northern Trust Corporation (Excerpt)

The Northern Trust Company
50 South La Salle Street
Chicago, Illinois 60903
(312) 630-6000

Northern Trust

CC:PA:LPD:PR (REG-128224-06)
Courier's Desk
Internal Revenue Service,
1111 Constitution Avenue, NW,
Washington, DC 20044

Testimony of Northern Trust Corporation before the
Internal Revenue Service
Public Hearing on Proposed Rules
Section 67 Limitations on Estates or Trusts
(REG-128224-96)
November 14, 2007

Ladies and Gentlemen:

On behalf of Northern Trust Corporation, I respectfully request permission to present oral comments at the public hearing scheduled for 10 am on November 14, 2007.

* * *

I have also enclosed a signed original and eight (8) copies of a written submission for the record.

Thank you for your consideration.

Very truly yours.

NORTHERN TRUST CORPORATION
By: /s/ Grace Allison
Grace Allison

Enclosures: 8 copies of topic outline
8 copies of written submission plus original

Testimony of Northern Trust Corporation before the Internal Revenue Service
Public Hearing on Proposed Rules
Section 67 Limitations on Estates or Trusts
(REG-128224-06)
November 14, 2007

Ladies and Gentlemen:

Thank you for the opportunity to make this presentation today.

I represent Northern Trust Corporation ("Northern Trust"), which has been in the business of administering trusts since its founding in 1889. Today, Northern is one of the largest trust companies in the world, with a network of 85 offices in 18 U.S. states, administering more than 15,000 irrevocable trusts nationwide.

* * *

The Plain Meaning of Section 67(e)

* * *

Disparate Treatment of Mutual Fund Fees.

It is also important to note that the proposed regulations, if made final, have the potential to disrupt the financial markets (and create another tax loophole) by providing a new incentive for all trusts to invest in mutual funds. This undoubtedly unintended consequence is caused by the asymmetry between the treatment of investment costs incurred by the mutual funds and the treatment, under the proposed regulations, of trust investment fees. The former are, pursuant to section 67(c)(2)(B), allowed as a direct offset to the fund's investment income; the latter, by regulation, would now be al-

lowed only to the extent that they exceed a 2% floor. To put it plainly, Treasury lacks the authority to require trustees to "unbundle" their fees, just as it would lack the authority to require mutual funds to pass their unbundled fees through to trust investors.

Impracticality.

In addition, the requirement to "unbundle" fees imposes an impractical burden on all trust companies, large and small, and would set a standard impossible to meet with any degree of precision. Put in an historical context, the proposed regulations rival the ill-fated carryover basis rules in the degree of administrative complexity they would entail if made final as proposed.

When providing trust services (whether as sole trustee or co-fiduciary), trustees must pay keen attention to the needs of beneficiaries. This means that services must be individualized—and the exact service mix will depend on a variety of factors, including the complexity of the family situation, the number of beneficiaries, the terms of the trust, and the type of assets under administration. For example, a trust administrator may spend many, many hours on a trust established for a disabled child or a distraught widow. In the same vein, a trust with 40 beneficiaries has different needs from a trust that benefits a single individual. Some of our accounts are simple trusts, requiring that all income be paid annually, with no discretion to distribute principal. In other trusts, however, distributions of both income and principal are left to the discretion of the trustee, with complex distribution standards requiring hours of fact-finding and analysis. In several of our large trust relationships, the predominant asset is closely-held stock of a family business; with this type of asset, discussions of family values are often as important—and far more difficult—than straight-forward investment briefings. As a consequence, the percentage of time devoted to trust

administration fluctuates widely from trust to trust and from year to year—and would be most difficult to quantify.

In pertinent part, the preamble to the proposed regulations states that:

> "whether costs are subject to the 2-percent floor . . . depends on the type of services provided, rather than on taxpayer characterizations or labels for such services."

Read literally, this would require Northern to detail its services on a minute-by-minute account-by-account basis. This is an impossibility in a corporate trustee environment, where some services are rendered to hundreds of trusts at the same time—and other services are required for more than one purpose. Is the cost of tax lot accounting, for example, most properly allocated to trust accounting (not subject to the 2% floor), to tax return preparation (not subject to the 2% floor) or to investment management (subject to the 2% floor)?

* * *

Conclusion.

In conclusion, we strongly urge Treasury and the IRS to withdraw the proposed Regulations, which are neither contemplated nor sanctioned by section 67, as ill-advised, impractical and expensive—both to the taxpayer and the IRS.

Respectfully submitted,

NORTHERN TRUST CORPORATION
By: /s/ Grace Allison
Grace Allison